

BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of)	
)	DOCKET NO. 19151
[Redacted])	
)	DECISION
Petitioners.)	
)	
)	

Procedural Background

On August 26, 2005, the Income Tax Audit Division (Division) of the Idaho State Tax Commission issued a Notice of Deficiency Determination [Redacted](Petitioner) asserting an Idaho income tax deficiency for the 2001 and 2002 taxable years. The Petitioner filed a timely appeal and petition for redetermination.

Subsequent to the appeal, the Petitioner and the Division discovered an error in the proposed deficiency. After additional communications with the taxpayer, the Division issued a modified Notice of Deficiency Determination on March 24, 2006. The Petitioner filed a written protest of the modified Notice of Deficiency Determination on May 24, 2006, requesting an informal conference.

The Tax Commission conducted the informal conference on August 3, 2006. Based on the information submitted by the Petitioner and the Division, the Tax Commission now issues this decision.

Issue

The issue in this case is whether the Petitioner's Idaho net operating loss deduction is subject to the deduction limitations set forth in section 382 of the Internal Revenue Code (IRC). During the taxable years 2001 and 2002, the Petitioner deducted net operating losses. The net

operating losses deducted in 2001 and 2002 were net operating losses carried forward from previous taxable years.

The Petitioner maintains it could not deduct the net operating losses at issue during the previous taxable years due to the limitations prescribed in IRC section 382. Accordingly, the Petitioner carried the losses forward as permitted under federal tax law to be deducted during the years at issue. The Division asserts the state deduction for the specific net operating losses at issue was not subject to the federal limitation cited by the Petitioner. Consequently the net operating losses should have been deducted by the Petitioner during the previous taxable years rather than carried forward and deducted during the years at issue.

Holding

The Tax Commission affirms the modified Notice of Deficiency Determination issued by the Division. The Idaho deduction for the net operating losses of an acquired corporation is not subject to the federal limitations set forth in the federal tax code. As a result, the Petitioner should have deducted the net operating losses during the 1995 through 2000 taxable years. Had the Petitioner deducted the losses in prior taxable years, the net operating losses would have been exhausted before the taxable years 2001 and 2002.

Facts

[Redacted] On July 21, 1995, the Petitioner purchased 100 percent of the stock [Redacted] The Petitioner purchased the stock from an unrelated corporation. Following the stock purchase, [Redacted] continued its separate corporate existence. Hence, the transaction was an acquisition rather than a merger.

At the time of the purchase, [Redacted] had a net operating loss carry-forward from calendar year 1994 of \$583,655. [Redacted] had a net operating loss of \$556,785 regarding the short year ending on the date of sale.

On its combined Idaho returns for the short tax year ending on December 31, 1995, and all subsequent taxable years through taxable year 2000, the Petitioner deducted certain losses [Redacted] as an "Other Deduction" rather than as a net operating loss deduction. The Petitioner listed the deduction as "other" based on its reasoning that the loss was a built-in loss deduction subject to the limitations of IRC section 382 rather than a net operating loss. It is the Petitioner's position that IRC section 382 required the Petitioner to deduct the built-in loss before it could deduct any of the net operating losses [Redacted] The Petitioner states that Idaho has incorporated the limitation of IRC section 382 by reference. The Petitioner notes that Idaho Code section 63-3002 declares that:

It is the intent of the Legislature by the adoption of this act, insofar as possible to make the provisions of the Idaho act identical to the provisions of the federal internal revenue code relating to the measurement of taxable income, . . . to achieve this result by the application of the various provisions of the federal internal revenue code relating to the definition of income, exceptions therefrom, deductions, "personal and otherwise", . . .

Based on this declaration of intent, the Petitioner maintains that the Tax Commission is required to follow the federal limitations imposed on post-acquisition net operating losses as set forth in Internal Revenue Code section 382 and the attendant federal regulations.

Law and Analysis

The Petitioner correctly notes that Idaho models its state income tax on the provisions of the federal tax code. However, Idaho has not incorporated all of the provisions of the Internal Revenue Code. Idaho Code section 63-3002 in its entirety states:

63-3002. DECLARATION OF INTENT. It is the intent of the legislature by the adoption of this act, insofar as possible to make

the provisions of the Idaho act identical to the provisions of the Federal Internal Revenue Code relating to the measurement of taxable income, to the end that the taxable income reported each taxable year by a taxpayer to the internal revenue service shall be the identical sum reported to this state, **subject only to modifications contained in the Idaho law**; to achieve this result by the application of the various provisions of the Federal Internal Revenue Code relating to the definition of income, exceptions therefrom, deductions (personal and otherwise), accounting methods, taxation of trusts, estates, partnerships and corporations, basis and other pertinent provisions to gross income as defined therein, resulting in an amount called "taxable income" in the Internal Revenue Code, and then to impose the provisions of this act thereon to derive a sum called "Idaho taxable income"; to impose a tax on residents of this state measured by Idaho taxable income wherever derived and on the Idaho taxable income of nonresidents which is the result of activity within or derived from sources within this state. **All of the foregoing is subject to modifications in Idaho law including, without limitation, modifications applicable to unitary groups of corporations, which include corporations incorporated outside the United States.**

Idaho Code section 63-3002 (emphasis added). *See also* Lockheed Martin Corporation v. Idaho State Tax Commission, 142 Idaho 790, 134 P.3d 641 (2006) (Federal tax law did not apply when the matter was governed by a specific state statute).

Net operating losses are specifically modified by Idaho statute. Instead of using the federal net operating loss definition, Idaho provides its own definition. Idaho Code section 63-3021.

63-3021. NET OPERATING LOSS. (a) The term "net operating loss" means the amount by which Idaho taxable income, after making the modifications specified in subsection (b) of this section, is less than zero.

(b) Add the following amounts:

(1) The amount of any net operating loss deduction included in Idaho taxable income.

(2) In the case of a taxpayer other than a corporation:

(i) Any amount deducted due to losses in excess of gains from sales

or exchanges of capital assets; and

(ii) Any deduction for long-term capital gains provided by this chapter.

(3) Any deduction allowed under section 151 of the Internal Revenue Code (relating to personal exemption) or any deduction in lieu of any such deduction.

(4) Any deduction for the standard or itemized deductions provided for in section 63 of the Internal Revenue Code, or section 63-3022(j), Idaho Code, except for any deduction allowable under section 165(c)(3) of the Internal Revenue Code (relating to casualty losses) pertaining to property physically located inside Idaho at the time of the casualty.

The term net operating loss is defined in relation to Idaho taxable income, not federal taxable income.

Moreover, Idaho Code section 63-3022(b) requires a taxpayer to add back to reportable taxable income any federal net operating losses deducted for the taxable year on the taxpayer's federal return. Once the federal net operating loss deduction is added back to the taxable income calculation, taxpayers may then deduct their Idaho net operating loss. The statute governing the time period in question stated in pertinent part:

63-3022. ADJUSTMENTS TO TAXABLE INCOME. The additions and subtractions set forth in this section, and in sections 63-3022A through 63-3022M, Idaho Code, are to be applied to the extent allowed in computing Idaho taxable income:

* * *

(c)(1) A net operating loss for any taxable year commencing on and after January 1, 1990, shall be a net operating loss carryback not to exceed a total of one hundred thousand dollars (\$100,000) to the three (3) immediately preceding taxable years. Any portion of the net operating loss not subtracted in the three (3) preceding years may be subtracted in the next fifteen (15) years succeeding the taxable year in which the loss arises in order until exhausted. The sum of the deductions may not exceed the amount of the net operating loss deduction incurred. . . .

Idaho Code section 63-3022 (1999). Neither the Idaho definition of net operating loss nor the above statute governing the deduction of net operating losses provides that an Idaho net operating loss is subject to the deduction limitations set forth in IRC section 382.

Generally, the absence of the IRC section 382 limitation benefits taxpayers. If the limitation applied to Idaho net operating losses, the deduction for most taxpayers would be limited (reduced). Thus a taxpayer generally would want to assert that the limitation does not apply.

The Tax Commission appreciates the Petitioner's predicament in this specific instance. Because of statutory time limitations, the Petitioner cannot amend its tax returns for the previous taxable years to claim a deduction. As a result, it would be advantageous to the Petitioner if the deduction available to it during the 1995 through 2000 taxable years was limited. If the limitation applied, the net operating losses would be carried forward and deducted during the years in question. In short, it is due to the unusual circumstances presented in this case that the taxpayer advocates the limitation should apply to pre-acquisition losses.

There are instances in which the federal limitation applies to a company's net operating losses. A merged corporation, as opposed to an acquired corporation, presents different circumstances, and the pre-merger net operating losses of a merged corporation are subject to different treatment than the pre-acquisition losses of an acquired corporation. In contrast to an acquired corporation, after a merger the corporation that is merged into another corporation no longer has a separate corporate existence. Several states have found that pre-merger net operating losses are extinguished by the merger and cannot be deducted by the company who purchased the merged corporation. See Richard's Auto City, Inc. v. Director, Division of Taxation, 140 N.J. 523, 659 A.2d 1360 (1995); Golf Digest/Tennis, Inc. v. Dubno, Commissioner of Revenue Services, 203 Conn. 455, 525 A.2d 106 (1987); and Fall River Canning Company v. Wisconsin Department of Taxation, 3 Wis.2d 632, 89 N.W.2d. 203 (1958).

A review of the Idaho net operating loss statutes cited above show that the statutes are silent as to the treatment of pre-merger net operating losses. As a result, the Tax Commission promulgated specific rules governing pre-merger losses. Income Tax Rule 200 provides:

200. NET OPERATING LOSS -- CORPORATIONS (RULE 200). Section 63-3021, Idaho Code. (3-20-97)

01. Unitary Taxpayers. Each corporation included in a unitary group must determine its respective share of the Idaho apportioned net operating loss incurred by the unitary group for the taxable year. A corporation's share of the net operating loss is computed using its Idaho apportionment factor for the year of the loss. The corporation must add or subtract its nonbusiness income or loss allocated to Idaho to its share of the apportioned loss. (3-20-97)

02. Net Operating Losses That Survive a Merger. Subject to the provisions of Sections 381 and 382, Internal Revenue Code, Idaho net operating losses incurred by a corporation will survive a merger. (3-20-97)

a. Changes in the location of a loss corporation's business or its key employees shall not be treated as a failure to satisfy the continuity of business requirements. (3-20-97)

b. If the pre-merger corporation conducted multistate operations, the Section 382, Internal Revenue Code, loss limitation is limited further by the pre-merger loss corporation's Idaho apportionment factor for the last taxable year preceding the date of the merger. (3-20-97)

IDAPA 35.01.01.200. Under subsection 2 of this rule, pre-merger losses are not extinguished, and the post-merger entity may deduct the losses in a limited fashion. The pre-merger losses are subject to the same limitations as federal net operating losses and the pre-merger losses of corporations that operated in more than one state must be apportioned in a specific manner.

As stated above, the Petitioner acquired [Redacted]company in a stock transaction and did not merge the company. The Division correctly concluded that Rule 200.02 does not apply.

The Petitioner conceded this point but then asserted that, as a matter of statutory interpretation, the IRC section 382 limitation should apply to all Idaho deductions of net operating losses.

The Tax Commission does not find support for the Petitioner's statutory interpretation. The Petitioner had the opportunity to avail itself of a deduction for net operating losses immediately after the acquisition without the IRC section 382 and apportionment limitations which apply to mergers. It is regrettable that the Petitioner did not avail itself of the opportunity when it was present, but the Tax Commission cannot change its interpretation of the statute after the fact for the benefit of this taxpayer.

Conclusion

WHEREFORE, the modified Notice of Deficiency Determination dated March 24, 2006, is hereby APPROVED and MADE FINAL.

IT IS ORDERED and THIS DECISION DOES ORDER that the Petitioner pay the following tax, penalty, and interest:

<u>YEAR</u>	<u>TAX</u>	<u>PENALTY</u>	<u>INTEREST</u>	<u>TOTAL</u>
2001	38,951	3,895	11,745	\$54,591
2002	29,468	2,947	6,993	39,408
Less: Credit for refund returned to the state of Idaho				(<u>13,363</u>)
TOTAL DUE				<u>\$80,636</u>

Interest is calculated through April 23, 2007.

DEMAND for immediate payment of the foregoing amount is hereby made and given.

An explanation of the Petitioner's right to appeal this decision is enclosed with this decision. As set forth in the enclosed explanation, you must deposit with the Tax Commission twenty percent (20%) of the total amount due in order to appeal this decision. The twenty percent

deposit in this case is \$16,127 and will be held as security for the payment of taxes until the appeal is finally resolved.

DATED this _____ day of _____, 2007.

IDAHO STATE TAX COMMISSION

COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that on this ____ day of _____, 2007, a copy of the within and foregoing DECISION was served by sending the same by United States mail, postage prepaid, in an envelope addressed to:

[REDACTED]
[REDACTED]

Receipt No.